

Message Text

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PASS BLUMENTHAL PARTY; TREAS FOR SYVRUD AND WIDMAN

E. O. 11652: N/A
TAGS: OVIP (BLUMENTHAL, W. MICHAEL)
SUBJ: VISIT OF SECRETARY BLUMENTHAL: ITALIAN ECONOMY ON EVE
OF VISIT

1. SUMMARY. LIKE THEIR COUNTERPARTS IN OTHER INDUSTRIAL COUNTRIES, ITALY'S ECONOMIC MANAGERS ARE FACED WITH THE DIFFICULT TASK OF RETURNING THE ECONOMY TO A MORE RAPID RATE OF GROWTH WITHOUT TRIGGERING ANOTHER BALANCE OF PAYMENTS CRUNCH AND A RETURN TO A DANGEROUSLY HIGH RATE OF INFLATION. SINCE THE ITALIAN ECONOMY SEEMS TO BE CAUGHT UP IN A DIFFICULT STOP/GO SITUATION, A LONG-TERM SOLUTION LIES NOT ONLY IN MAINTAINING AN EFFECTIVE SHORT-TERM STABILIZATION PROGRAM BUT ALSO IN SOLVING SOME OF THE COUNTRY'S STRUCTURAL PROBLEMS. THE GOVERNMENT IS COMING UNDER INCREASING PRESSURE TO REFLATE BUT HAS SO FAR REMAINED FIRM IN ITS RESOLVE TO CONTINUE WITH ITS CURRENT ECONOMIC PROGRAM. UNFORTUNATELY, THE BURDEN OF THE PRESENT RESTRICTION POLICIES FALLS TOO HEAVILY ON THE PRIVATE SECTOR, WHICH IS HINDERING THE CREATION OF NEW JOBS. THE BASIC REASONS FOR THIS STATE OF AFFAIRS ARE THE GOVERNMENT'S INABILITY TO REDUCE PUBLIC EXPENDITURES, A MAJOR WEAKNESS IN ITALY'S DEMAND MANAGEMENT POLICIES, AND

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HIGH LABOR COSTS. END SUMMARY.

2. THE PRUPOSE OF THIS MESSAGE IS TO GIVE YOU A FEEL FOR SOME OF THE MAJOR ISSUES CONFRONTING YOUR ITALIAN INTERLOCUTORS. IT IS NOT INTENDED TO DUPLICATE THE DETAILED BRIEFING WHICH WASHINGTON HAS PREPARED FOR YOUR.

3. THE MAIN POLICY ISSUE FACING ITALY'S ECONOMIC MANAGERS AS THEY LOOK AHEAD TOWARD 1978 IS HOW TO ACHIEVE AN ADEQUATE GROWTH RATE WITHOUT COMPLETELY REVERSING THE PROGRESS MADE DURING THE PAST YEAR IN REDUCING INFLATION AND TURNING AROUND THE CURRENT ACCOUNT DEFICIT. THE AUTHORITIES ARE FACED WITH A PARTICULARLY DIFFICULT DILEMMA. THE EXPERIENCE OF THE PAST FEW YEARS HAS REPEATEDLY DEMONSTRATED THAT ITALY IS CAUGHT UP IN A DIFFICULT STOP/GO SITUATION. WHILE THE ECONOMY HAS SHOWN A CAPACITY TO RESPOND QUICKLY TO POLICY CHANGES, THE AUTHORITIES HAVE NOT BEEN ABLE TO COME UP WITH A CONSISTENT SET OF POLICIES WHICH WILL SIMULTANEOUSLY PROVIDE EXTERNAL STABILITY AND A NON-INFLATIONARY GROWTH RATE SUFFICIENT TO COPE WITH THE UNEMPLOYMENT PROBLEM. THE BASIC REASON FOR THIS STATE OF AFFAIRS IS THAT THE ECONOMY IS BURDENED WITH A NUMBER OF STRUCTURAL DEFECTS, SUCH AS GROWING DEPENDENCE ON IMPORTS FOR AGRICULTURAL PRODUCTS, LARGE INEFFICIENCIES IN THE PUBLIC SECTOR, THE SHAKY FINANCIAL SITUATION OF INDUSTRY (WHICH IS HIGHLY LEVER-AGED), BOTH PUBLIC AND PRIVATE, AND AN INFLEXIBLE SYSTEM OF LABOR RELATIONS. WHENEVER THE BALANCE OF PAYMENTS RUNS INTO DEFICIT, THE AUTHORITIES PUT ON THE BRAKES--PRIMARILY THROUGH CREDIT AND EXCHANGE MARKET CONTROLS--AND THE BALANCE OF PAYMENTS SHORTLY SHIFTS INTO SURPLUS. SOON PRESSURES BUILD UP ON THE GOVERNMENT TO LOOSEN THE CONTROLS AND REFLATE BECAUSE OF THE LIMITED OFFICIAL USE

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ECONOMIC/SOCIAL COSTS OF THE ADJUSTMENT, WHICH HAVE BEEN ON THE RISE IN RECENT YEARS. THIS HAS BEEN ITALY'S EXPERIENCE IN THE YEARS 1975-1977.

4. THE ECONOMIC SITUATION HAS AGAIN REACHED THAT POINT WHERE PRESSURES ARE BUILDING ON THE GOVERNMENT TO EASE UP ITS RESTRICTIVE PROGRAM IN FAVOR OF MORE EXPANSIONARY MEASURES. FIRST AND FOREMOST OF THESE PRESSURES IS THE APPARENT INCREASE IN UNEMPLOYMENT AND THE PROSPECTS FOR A FURTHER RISE IN UNEMPLOYMENT IF CURRENT POLICIES ARE CONTINUED. UNIONS CONSEQUENTLY CALL FOR GOVERNMENT AND BUSINESS INVESTMENT PROJECTS TO CREATE NEW JOBS, WHILE DEMANDING AT THE SAME TIME THAT THE GOVERNMENT SAVE FAILING STATE ENTERPRISES IN ORDER TO PREVENT LAY-OFFS OF A SUBSTANTIAL NUMBER OF EMPLOYEES. THE MOST SERIOUS PROBLEM REGARDING THE UNEMPLOYED IS THE NUMBER OF YOUNG WHO ARE SEEKING THEIR FIRST JOB. OFFICIAL STATISTICS PUT THE NUMBER OF UNEMPLOYED IN JULY (NOT SEASONALLY ADJUSTED) AT 1.692 MILLION, OR 7.7 PERCENT OF THE LABOR FORCE. (BY US BUREAU OF LABOR STATISTICAL CRITERIA, ITALY'S UNEMPLOYMENT IS OVERSTATED BY PERHAPS AS MUCH AS 50 PERCENT.) OF THESE, FULLY 1,253 MILLION ARE CALCULATED TO BE YOUTHS

IN THE AGE GROUP 14 TO 29, OF WHOM 410,000 HAVE HIGH SCHOOL DIPLOMAS OR BETTER. THE UNEMPLOYED YOUTH REPRESENT 17 PERCENT OF YOUTHS IN THE WORK FORCE, WHILE UNEMPLOYED PERSONS ABOVE AGE 30 ARE ONLY 2.7 PERCENT OF THAT AGE GROUP IN THE WORK FORCE. IT IS RECOGNIZED THAT THE STRUCTURE OF UNEMPLOYMENT IN ITALY IS NOT RADICALLY DIFFERENT FROM OTHER INDUSTRIALIZED COUNTRIES, BUT IN ITALY IT IS CAUSING PARTICULAR PROBLEMS, NOT THE LEAST OF WHICH IS THE RISING VIOLENCE AMONG YOUNG RADICAL GROUPS AND THE SOCIAL BURDEN BORNE BY THE COUNTRY UNABLE TO SATISFY YOUTH EXPECTATIONS FOR WHITE COLLAR JOBS.

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PASS BLUMENTHAL PARTY; TREAS FOR SYVRUD AND WIDMAN

5. THE SHARPER THAN EXPECTED FALL IN INDUSTRIAL PRODUCTION AND THE FINANCIAL BIND OF INDUSTRY, COMBINED WITH THE UNEMPLOYMENT SITUATION, HAS PROMPTED GUIDO CARLI, FORMER GOVERNOR OF THE BANK OF ITALY AND NOW PRESIDENT OF CONFINDUSTRIA (FEDERATION OF INDUSTRIALISTS) TO CALL FOR AN EASING OF CREDIT TO THE PRIVATE SECTOR, INCLUDING A CALL ON THE BANKING SYSTEM TO CUT THE "PRIME RATE" (CURRENTLY AT 17 PERCENT) BY 2-3 PERCENTAGE POINTS. CARLI IS CONCERNED ABOUT THE POOR OUTLOOK FOR GROWTH IN 1978 AND THE CONTINUING AND INCREASING UNEMPLOYMENT PROBLEM. CARLI'S GENERAL APPROACH, IF NOT ITS SPECIFIC DETAILS, HAS ALREADY BEEN ADVOCATED BY ECONOMIST ANDREATTA, WHO IS A SENATOR WITHIN THE PRIME MINISTER'S OWN PARTY. THE COMMUNIST PARTY, WHICH ONE WOULD EXPECT TO LEAD THE OPPOSITON AGAINST PRESENT POLICIES, HAS ESPOUSED AUSTERITY AS NECESSARY TO ITALY'S DEVELOPMENT. (IN ONE VERY INTERESTING EXCHANGE IN THIS PUBLIC DEBATE, A CRHISTIAN DEMOCRATIC SPOKESMAN RECENTLY ACCUSED THE COMMUNISTS OF HAVING EMBRACED MILTON

FRIEDMAN'S IDEAS.)

6. THE GOVERNMENT HAS TAKEN THE POSITION THAT REFLATION NOW WOULD BE PREMATURE AND THAT SUCH A STEP WOULD ONLY LEAD TO A REPETITION OF THE EVENTS OF 1975 WHEN SLACKENING OF LIMITED OFFICIAL USE

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MONETARY RESTRICTIONS HELPED SPUR A SPLURGE IN IMPORTS AND CAPITAL FLIGHT. THE OFFICIAL FORECAST FOR 1978 IS CONSERVATIVE; IT SHOWS A GROWTH RATE OF ONLY 2.0 PERCENT (UNCHANGED FROM 1977), A TARGET, IT FEELS, COMPATIBLE WITH A SURPLUS ON CURRENT ACCOUNT AND FURTHER DECELERATION IN THE RATE OF INFLATION (DOWN TO AN ANNUAL AVERAGE OF 12 PERCENT FROM THIS YEAR'S PROJECTED 18 PERCENT). WE BELIEVE THE FORECAST OPTIMISTIC BECAUSE IT ASSUMES PUBLIC SECTOR DEFICIT AND CREDIT EXPANSION TARGETS THAT WILL BE DIFFICULT TO MEET BECAUSE OF CERTAIN ASSUMPTIONS ON THE DEFICIT SIDE AND PRESSURES ON THE CREDIT SIDE.

7. THE PROBLEM WITH THE GOVERNMENT'S ECONOMIC PROGRAM IS THAT ITS RESTRICTIVE POLICIES FALL TOO HEAVILY ON THE PRIVATE SECTOR. THE GOVERNMENT'S CASH BUDGET DEFICITS ARE ABSORBING AN INCREASING PORTION OF THE ECONOMY'S SAVINGS AND CREDIT AS POLICIES ARE MORE SUCCESSFUL IN CONTROLLING CREDIT TO THE PRIVATE SECTOR THAN CONTROLLING GOVERNMENT EXPENDITURES. THE PRIVATE SECTOR, AS A RESULT, FINDS IT INCREASINGLY DIFFICULT (AND EVER MORE COSTLY) TO FINANCE ITS INVESTMENTS. IN AN ECONOMY THAT NEEDS NEW PRODUCTIVE INVESTMENTS TO BECOME MORE COMPETITIVE AND CREATE MANY NEW JOBS, THIS SITUATION IS RATHER OMINOUS FOR THE FUTURE. THE GOVERNMENT RECOGNIZED THIS DANGER, BUT HAS SO FAR FAILED TO TURN THIS SITUATION AROUND. BUT NOT FOR LACK OF EFFORT. RECENTLY THE TREASURY MINISTER TRIED TO PUT A LID ON THE PENSIONS OF THOSE CONTINUING TO DRAW A SALARY BUT WAS FORCED TO WITHDRAW THE PROPOSAL UNDER PRESSURE FROM LEADERS OF THE CHRISTIAN DEMOCRATIC PARTY. WITH IT WENT AN EFFORT TO REDUCE EXPENDITURES BY 1,650 BILLION LIRE, WHICH THE GOVERNMENT HOPES TO MAKE UP BY CUTTING BACK OTHER PROGRAMS IF THE DEFICIT IS TO BE KEPT AT THE OFFICIALLY PROJECTED LEVEL. ALTHOUGH SOME OF THE CRITICISMS OF THE LIMITED OFFICIAL USE

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PENSION PROPOSAL WERE JUSTIFIED, THE FACT THAT THE GOVERNMENT WAS UNABLE TO GET SUPPORT FROM EVEN ITS OWN PARTY DOES NOT AUGUR WELL FOR ITS SUCCESS IN MAKING PROGRESS IN CONTROLLING GOVERNMENT EXPENDITURES. THE INABILITY TO

REDUCE PUBLIC EXPENDITURES IS A MAJOR WEAKNESS IN ITALY'S DEMAND MANAGEMENT POLICIES.

8. THE OTHER AREA WHICH RESTRICTS THE FREEDOM OF DEMAND MANAGEMENT IS THE SYSTEM OF WAGE INDEXATION. BECAUSE OF THE VIRTUALLY COMPLETE PROTECTION OF WAGES AGAINST INFLATION, ECONOMIC MANAGERS CAN NO LONGER COUNT ON EROSION OF REAL WAGES THROUGH INFLATION TO MAINTAIN ITALY'S COMPETITIVENESS. WAGE INDEXATION ALSO MAKES IT DIFFICULT FOR THE AUTHORITIES TO USE INFLATION TO RESTORE THE RELATIVE PRICE AND WAGE STRUCTURE, AND THUS RESTORE EMPLOYMENT IN SECTORS THAT HAVE ARBITRARILY SET NON-EQUILIBRIUM WAGE LEVELS OR PRICES. EVEN THE LEADERS OF THE COMMUNIST-DOMINATED LABOR UNION HAVE RECOGNIZED SOME OF THE DANGERS OF THE WAGE INDEXATION SYSTEM. HOWEVER, THEY COULD ONLY AGREE TO MINIMAL CHANGES DURING THE GOVERNMENT'S NEGOTIATIONS WITH THE IMF FOR THE LAST STAND-BY FOR FEAR OF LOSING THE SUPPORT OF THEIR MEMBERSHIP. ITALY IS, THEREFORE, AT A DISADVANTAGE VIS-A-VIS ITS MAJOR TRADING PARTNERS WHICH DO NOT HAVE SUCH A SYSTEM. IN ADDITION, ITALIAN FINANCIAL OFFICIALS BELIEVE THAT WAGE INDEXATION IS THE CAUSE OF THE "VICIOUS CIRCLE" THAT THEY BELIEVE IS OPERATIVE IN ITALY SO THAT, IN EFFECT, A DOWNWARD MOVEMENT IN THE EXCHANGE RATE WOULD NOT BENEFIT THE COUNTRY'S COMPETITIVE POSITION. ALTHOUGH ONE CAN DISPUTE THE VALIDITY OF THIS ARGUMENT, THE IMPORTANT THING IS THAT THE CENTRAL BANK OPERATES IN THE EXCHANGE MARKET AS IF THE THEORY HOLDS, I.E., IT TENDS TO DEFEND THE RATE BEYOND THE POINT OBJECTIVE CRITERIA WOULD JUSTIFY.

9. IN SUMMARY, ITALY'S SUCCESS AT STABILIZATION DURING THE PAST YEAR HAS BEEN MOST HEAVILY AT THE EXPENSE OF THE LIMITED OFFICIAL USE

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PRIVATE SECTOR AND COMES AT SUBSTANTIAL COST IN TERMS OF OVERALL DOMESTIC GROWTH AND EMPLOYMENT; HOWEVER, A MAJOR SHIFT IN POLICY TOWARD REFLATION NOW WOULD MOST LIKELY LEAD TO ANOTHER BALANCE OF PAYMENTS AND INFLATION CRUNCH. IN ASSESSING ITALY'S PERFORMANCE UNDER THE LETTER OF INTENT, WE SHOULD THEREFORE FOCUS NOT ONLY ON BUDGET DEFICITS AND CREDIT EXPANSION, VARIABLES WHICH CAN BY NO MEANS BE OVERLOOKED, BUT ALSO ON THE STRUCTURAL IMPROVEMENTS TO WHICH ITALY COMMITTED ITSELF TO THE IMF. UNLESS PROGRESS IS MADE ON THIS FRONT, PARTICULARLY CURBING PUBLIC EXPENDITURES AND REDUCING LABOR COSTS, IT WILL BE DIFFICULT FOR ITALY TO INCREASE PRODUCTIVE INVESTMENT WHICH ARE ESSENTIAL TO CREATE NEW JOBS. GARDNER

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